

constitute “arranging” for the extension of credit to purchase or carry securities in violation of the prohibitions of §§ 220.7(a) and 220.8 of Regulation T.

[37 FR 6568, Mar. 31, 1972]

§ 220.125 [Reserved]

§ 220.126 Put and call options.

(a) The Board has been asked several questions about the treatment of put and call options and combinations thereof (puts and calls) under Regulation T (Part 220). These questions involve § 220.3(d) Adjusted debit balance, § 220.3(h) Unissued securities, § 220.4(c) Special cash account and § 220.4(d) Special arbitrage account.

(b) The special cash account under § 220.4(c) may be used only for those bona fide transactions in securities in which the creditor accepts in good faith the customer’s agreement, if he is a purchaser, that (if he does not already have sufficient funds in the account) he will promptly make full cash payment for the security and does not contemplate selling it prior to making such payment, and if he is a seller, that he or his principal owns the security and (if it is not already held in the account) it will be promptly deposited therein. It is the Board’s view that subject to these requirements, a creditor may effect in a special cash account—

(1) The purchase or sale for cash of a put or call;

(2) The exercise of a call, provided that full cash payment for the purchased stock is deposited in the account promptly and in any event prior to the release of the proceeds of any resale of such security; and

(3) The endorsement, guarantee or issuance of a put or call if (in the case of a put) sufficient funds to purchase the underlying stock or (in the case of a call) the underlying stock itself are held in the account.

(c) Generally a put or call option refers to an agreement to sell a security or to purchase a security, at some future time. Although the agreement may itself be deemed to be a security, it cannot be an “unissued” security, under § 220.3(h) or § 220.4(c)(3), for the reasons set forth by the Board in discussing a similar question in regard to mutual fund shares (1962 Bulletin 1427;

12 CFR 220.118). Accordingly, in respect of a transaction involving puts or calls, payment is required within the period of time provided by § 220.3(b)(1) if the transaction occurs in the general account (or if the transaction occurs in a special cash account, by § 220.4(c)(2)) without regard to whether there has been a delay in obtaining the endorsement, or for any other reason the option has not yet technically been issued.

(d) A question has been asked whether puts and calls may be considered to be securities which are exchangeable or convertible into other securities within 90 calendar days, without restriction other than the payment of money. If held in a general account, such exchangeable or convertible securities are acceptable in lieu of the margin required in respect of a short sale under § 220.3(d)(3). If held in a special arbitrage account under § 220.4 (d), exchangeable or convertible securities will support the sale, for purposes of bona fide arbitrage, of the security into which they are so exchangeable or convertible. The Board concludes that puts and calls may not be considered, for either purpose, as securities that are exchangeable or convertible into other securities. The Board’s view stems from the policies underlying the sections in question.

(e) The margin restrictions in respect of short sales were imposed in order that:

* * * traders on the short side of the market should not be in a position, with a given amount of funds, to exert a greater influence on the market than they could with the same amount of funds if they were trading on the long side. (Annual Report, Board of Governors, 1937, p. 208.)

Permitting call options to be used in lieu of the margin required in respect of a short sale would be inconsistent with that general policy (parallel considerations would apply in the case of puts).

(f) The use of the special arbitrage account under § 220.4(d) is limited to the simultaneous purchase and sale of the same or equivalent securities for the purpose of taking advantage of a difference in price. Arbitrage is permitted to be carried on without additional deposit of margin because it

tends to equalize prices between markets and between equivalent securities. Because the relatively high initial cost of a put or call option must be deducted from the potential profit due to the disparity in price between the two securities, it is not likely that true arbitrage would take place between an option and an underlying security. Such options would be used, rather, for purposes of "hedging," that is to say, to protect an investor against loss while he holds a security in the hope of profiting by changes in its price. Such market strategies may be beneficial to individual investors. However, they do not perform a comparable market function.

(g) Section 221.2 of this chapter provides that "a bank may extend and may maintain any credit for the purpose specified in §221.1, without regard to the limitations prescribed therein, or in §221.3(t), if the credit comes within any of the following descriptions." Paragraph (j) contains the following description: "Any credit extended to a member of a national securities exchange for the purpose of financing his or his customers' bona fide arbitrage transactions in securities." The Board has concluded that a purchase of a put or call is not embraced within the term in §220.4(d) "a purchase of a security which is, without restriction other than the payment of money exchangeable or convertible * * * into a second security" so as to qualify such purchase, when effected together with an offsetting sale of the second security, as a bona fide arbitrage transaction, and the Board's conclusion is also applicable to paragraph (j) of §221.2.

[38 FR 5237, Feb. 27, 1973]

§ 220.127 Independent broker/dealers arranging credit in connection with the sale of insurance premium funding programs.

(a) The Board's September 5, 1972, clarifying amendment to §220.4(k) set forth that creditors who arrange credit for the acquisition of mutual fund shares and insurance are also permitted to sell mutual fund shares without insurance under the provisions of the special cash account. It should be understood, of course, that such account provides a relatively short credit

period of up to 7 business days even with so-called cash transactions. This amendment was in accordance with the Board's understanding in 1969, when the insurance premium funding provisions were adopted in §220.4(k), that firms engaged in a general securities business would not also be engaged in the sale and arranging of credit in connection with such insurance premium funding programs.

(b) The 1972 amendment eliminated from §220.4(k) the requirement that, to be eligible for the provisions of the section, a creditor had to be the issuer, or a subsidiary or affiliate of the issuer, of programs which combine the acquisition of both mutual fund shares and insurance. Thus the amendment permits an independent broker/dealer to sell such a program and to arrange for financing in that connection. In reaching such decision, the Board again relied upon the earlier understanding that independent broker/dealers who would sell such programs would not be engaged in transacting a general securities business.

(c) In response to a specific view recently expressed, the Board agrees that under Regulation T:

* * * a broker/dealer dealing in special insurance premium funding products can only extend credit in connection with such products or in connection with the sale of shares of registered investment companies under the cash accounts * * * (and) cannot engage in the general securities business or sell any securities other than shares * * * (in) registered investment companies through a cash account or any other manner involving the extension of credit.

(d) There is a way, of course, as has been indicated, that an independent broker/dealer might be able to sell other than shares of registered investment companies without creating any conflict with the regulation. Such sales could be executed on a "funds on hand" basis and in the case of payment by check, would have to include the collection of such check. It is understood from industry sources, however, that few if any independent broker/dealers engage solely in a "fund on hand" type of operation.

[38 FR 11066, May 4, 1973]